Paying Executives With Debt

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This is taken from my 8/5/18 response to the UK government's Executive Pay Inquiry. The full response is at http://bit.ly/ExecPayInquiry.

The financial crisis saw CEOs undertake risky actions that cost billions of pounds. Examples included irresponsible subprime lending and over-expansion through excessive leverage. Moreover, this problem extends beyond financial institutions to other corporations. For example, Punch Taverns accumulated £2.3bn of debt through an expansion spree before the financial crisis, which has long been threatening its viability.

CEOs have incentives to take excessive risk because they are paid primarily with equity and long-term incentive plans (LTIPs). Their value rises if a risky project pays off, but cannot fall below zero if things go wrong – so the CEO has a one-way bet. Of course, executives are incentivised not only by their equity and LTIPs, but the threat of being fired and reputational concerns. However, the risk of being fired mainly depends on the incidence of bankruptcy and not the severity of bankruptcy. For example, assume that the CEO is fired upon any level of bankruptcy. Then, regardless of whether debtholders recover 90p per £1 (a mild bankruptcy) or 10p per £1 (a severe bankruptcy), the CEO will be fired and her equity will be worthless. Thus, if a firm is teetering towards liquidation, rather than optimally accepting a mild bankruptcy, the CEO may "gamble for resurrection". If the gamble fails, the bankruptcy will be severe, costing debtholders (and society – including employees, customers, and suppliers) billions of pounds – but the CEO is no worse off than in a mild bankruptcy, so she might as well gamble.

One solution I have heard is to remove limited liability *for the firm*. I view this as a highly undesirable solution that would throw the baby out with the bathwater. Ordinary savers and pensioners would be unable to invest in equity, and thus share in the profits earned by companies. A much better solution is to effectively remove limited liability *for the CEO* by giving her extra penalties if the firm becomes bankrupt. Edmans and Liu (2011) show that this can be done by replacing some of the CEO's salary with unsecured debt. The value of debt is eroded in bankruptcy – and the decline is greater the more severe the bankruptcy – and so she suffers from bankruptcy along with debtholders and society. As a result, the CEO internalises the costs to debtholders of undertaking risky actions. Just as restricted stock makes CEOs think like owners, restricted debt makes CEOs think like creditors, and so now take into account the risk of bankruptcy.

One may wonder why compensation committees - who are elected by shareholders – should care about debtholders. This is because if potential lenders expect the CEO to risk-shift, they will demand a high interest rate and covenants, ultimately costing shareholders.

Debt-Based Incentives: The Evidence

There are many proposed solutions to compensation, but most of these proposals have not been backed up by evidence showing whether they will actually help. Evidence is particularly important because the entire history of executive compensation has been littered with examples of well-intentioned remedies that actually backfire.

Here, we have significant evidence to guide us. In the U.S., many CEOs already receive debt-like securities in the form of defined benefit pensions and deferred compensation. These instruments have equal priority with unsecured creditors in bankruptcy and so are effectively debt. If the firm goes mildly bankrupt and creditors recover 90c per $1, the pension is worth 90c per $1. If the firm goes severely bankrupt and creditors recover 10c per $1, the pension is worth 10c per $1. Thus, a CEO with debt-based pay will consider both the incidence and severity of bankruptcy – even in absence of changes to the law – and take actions to mitigate both.

Since 2006, detailed data on debt-like compensation has been disclosed in the U.S., allowing us to study its effects. The seminal paper by Sundaram and Yermack (2007) found that debt-like compensation is associated with lower bankruptcy risk. Wei and Yermack (2011) found that, after the increased disclosure of debt-like pay in 2006, bond prices increased at the revelation of significant CEO debt incentives. Anantharaman, Fang, and Gong (2014) found that it is associated with looser covenants and lower bond yields, suggesting that debtholders are indeed reassured by the CEO's lower incentives to risk-shift. Shareholders benefit from looser covenants and lower bond yields, and so debt-based pay grows the pie rather than redistributing a slice of the pie from shareholders to creditors. Cassell et al. (2012) find that debt-based pay is associate with lower stock return volatility and financial leverage, and higher asset liquidity. Campbell, Galpin, and Johnson (2016) provide suggestive evidence that shareholder value rises when a CEO's level of debt-based pay moves closer to those at peer firms with similar characteristics. All of the above papers are published in the very top finance and management journals. (One must be careful about using academic research, because there is a very wide dispersion in the quality of research and many papers are either unpublished, or published in journals with lax standards).

Indeed, UBS and Credit Suisse have started to pay bonuses in the form of contingent convertible (CoCo) bonds. The former President of the Federal Reserve Bank of New York, William Dudley, proposed it to change the risk culture of banks, and current Executive Vice President Michael Held reiterated the idea in a speech on 25 April, 2018. In Europe, the November 2011 Liikanen Commission recommended bonuses to be partly based on "bail-inable" debt.

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